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C O N F I D E N T I A L SECTION 01 OF 02 BAKU 000429

SIPDIS

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TAGS: [ECON](#) [EFIN](#) [ETRD](#) [PGOV](#) [PREL](#) [AJ](#)

SUBJECT: IFIS WORRY ABOUT INCREASED INFLATION, PLEASED BY  
IMPROVEMENTS IN BUSINESS ENVIRONMENT

Classified By: DEPUTY CHIEF OF MISSION DON LU PER REASONS 1.4 (B,D).

¶1. (C) SUMMARY: At an April 30 lunch with the Ambassador Derse, local representatives from the International Financial Institutions worried about the impact of increased GOAJ spending, including stepped-up transfers from the State Oil Fund to the consolidated budget. The 2008 supplemental budget will increase by 40 percent, and the IMF believes 2008 inflation will top 22 percent. (A USAID-funded study estimated 2008 inflation at more than 28 percent.) Azerbaijan looks to improve significantly in the next "Doing Business" report and may be included in the list of top 10 reformers for the period, due to Economic Development Minister Babayev's new business-friendly initiatives, including a corporate governance code and new investment law.  
END SUMMARY.

#### LARGE SUPPLEMENTAL BUDGET

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¶2. (C) At a lunch with Ambassador Derse on April 30, local representatives from the International Monetary Fund (IMF), World Bank, United Nations Development Programme (UNDP), International Financial Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) expressed concern at the Government of Azerbaijan's (GOAJ) expansionary fiscal policy. In particular, the IFIs are especially troubled by the GOAJ's supplemental budget which has been submitted to Parliament and increases spending by approximately 40 percent. (Note: The exact details of the supplemental budget have not yet been made public.) Press reports indicate that the government will fund salary and pension increases, as well as increases in defense spending. The IMF rep said that the 2008 consolidated state budget looked to increase by more than 76 percent compared to the 2007 consolidated budget.

#### LARGE TRANSFERS FROM OIL FUND

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¶3. (C) The IMF resident representative said that according to the supplemental budget the GOAJ would transfer an additional USD 2.6 billion from the State Oil Fund to the budget. In 2008, the GOAJ will transfer a total of USD 3.8 billion from the Oil Fund to the budget. The Oil Fund stands to receive up to USD 12 billion in energy revenues in 2008. Calling the Oil Fund completely transparent, the IMF rep lamented the large transfers from the Oil Fund to the budget since government expenditures were not transparent. He said that the recent IMF Article IV mission had cautioned the GOAJ on the risks of wage-cost spiral but that the GOAJ had obviously not heeded the warnings from the IMF.

14. (C) Inflationary pressures continue to grow within the economy. The IMF resident representative told the group that inflation from March 2007 to March 2008 had reached 18.2 percent, noting that this figure did not include the January 2007 increase in utility prices. He said that the IMF had revised its 2008 inflation estimate from the high teens to more than 22 percent. The GOAJ has recently changed how it handles monetary policy, pegging the Azerbaijani manat to a basket of currencies, including the U.S. dollar and Euro. This monetary adjustment should enable the manat to appreciate and alleviate some of the price increases. The IFIs all agreed that the global increase in agricultural and commodity prices has contributed to rising prices in Azerbaijan. They also noted that the GOAJ is concerned with food security and has requested some assistance from the IFIs with analyzing possible ways to reduce food costs.

DOING BUSINESS IMPROVEMENT

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15. (C) On a positive note, Azerbaijan looks to improve significantly in the next "Doing Business" report and may be included in the list of top 10 reformers for the period. Economic Development Minister Babayev's efforts have been key to the improvement and the IFIs all applauded Babayev's work. The IFC representative briefed the lunch group on Azerbaijan's efforts to improve its ranking, including the business registration "one-stop-shop" at the Ministry of Taxes. The IFC has been actively working with the GOAJ to improve its ranking. Since opening the "one-stop-shop" there has been a 75 percent increase in new business licenses and a significant drop in the time it takes to register a new

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business. The IFC noted that Azerbaijan was the first country to pay on its own for its "one-stop-shop," a USD 4 million cost.

16. (C) Also contributing to Azerbaijan's "Doing Business" ranking, the GOAJ is working on a variety of business-friendly initiatives, including a corporate governance code and new investment law. The Ministry of Economic of Development has recently formed a corporate governance task force with a variety of ministries in order to coordinate the GOAJ's efforts to improve investor relations. The IFC rep said that the GOAJ needs to complete all its efforts by May 30 in order to be included in the upcoming report. The GOAJ is also examining the number and kinds of licenses and permits, looking for areas to reduce the amount of paperwork required for business activities. The GOAJ has also simplified the process to obtain a construction license and has named the Ministry of Emergency Situations as the action ministry for construction issues.

CAPITAL PROJECTS

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17. (C) The World Bank and EBRD representatives told the group that the GOAJ has recently changed its preferences on large road projects from asphalt roads to concrete roads. They hinted that some in the GOAJ have interests in the concrete business. In one instance, the GOAJ cancelled an EBRD construction contract with an Italian firm and gave it to local construction group Akkord, a company reportedly associated with Minister of Emergency Situations Kamalladdin Heydarov. In addition, the IMF said that he has heard from contacts that the MES has assumed an official role of approving all decrees regarding capital infrastructure projects in order to ensure safety and security regulations. The IMF representative believes that the MES is continuing its efforts to consolidate official and unofficial influence and power by becoming the center of business regulation and oversight.

COMMENT

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18. (C) The concerns raised by the IFIs over the GOAJ's expansionary fiscal policy are not new or unexpected. Increasing inflation continues to be a key issue, especially with the upcoming presidential elections. A recent USAID-funded study indicated that year-over-year inflation may actually be 23.3 percent, higher than the IMF's 18.2 percent estimate. The GOAJ is clearly taking a calculated risk that the benefits of greater spending outweigh the inflationary risks. The GOAJ's moves to increase the business environment are positive. We are hearing anecdotal evidence that suggests corruption in Azerbaijan is transitioning to larger scale construction and infrastructure projects that benefit key ministers, while decreasing slightly in the traditional areas of small-scale petty bribery and extortion.

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